

**MUNICIPAL ACCOUNTING,
REPORTING AND AUDITING**

**STANDARDS AND CURRENT
PRACTICE IN THE CZECH
REPUBLIC**

Prepared for

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EXECUTIVE SUMMARY

OBJECTIVES

The objective of this paper is to assist the Finance Committee of the Union of Towns and Communities, the Ministry of Finance, and USAID to identify and address key issues related to financial accounting, reporting and auditing standards and practices for municipalities of the Czech Republic. Another objective is to review European Union financial management and accounting directives to see if they mandate standards that are applicable to the municipal sector in the Czech Republic. The paper is organized around three main topics:

- Standards for municipal accounting and financial reporting
- Financial reporting practices
- Auditing standards and practices

STANDARDS FOR MUNICIPAL ACCOUNTING AND FINANCIAL REPORTING

Internationally, accounting and financial reporting standards are often established by independent standards setting authorities or boards. In the United States, for example, the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB) establish the accounting and financial reporting standards for the private and public sectors, respectively. In the Czech Republic, there does not exist an independent standards setting body. Rather, the accounting and financial reporting framework and principles are established in law. The emphasis of accounting and reporting standards is on legal compliance.

The Czech Republic has adopted the provisions of the Fourth and Seventh European Union Directives concerning accounting and financial reporting standards in the private sector and in state enterprises. However, these EU directives are not specifically applicable to accounting and financial reporting by governments. Czech lawmakers are free to establish government accounting standards, drawing upon the EU accounting directives for companies as appropriate.

FINANCIAL REPORTING PRACTICES

Municipal financial reporting in the Czech Republic focuses on the fulfillment of revenues and expenditures for the fiscal year—i.e., on compliance with the laws concerning revenue generation and expenditures, and on the correspondence between actual and budgeted revenues and expenditures. Financial reports show whether current year revenues are sufficient to meet current year expenditures and whether the resources are obtained and used consistent with the approved budget. The predominant user of municipal financial reports is the Ministry of Finance.

However, the users of municipal financial statements are changing and so are their needs. First, a growing number of municipalities are seeking to raise credit in the domestic and international markets, as witnessed by the 19 municipal bonds issued between 1992 and 1997 and the large number of long-term bank loans. Underwriters, credit rating agencies, potential investors, and banks have become important users of municipal financial statements. Second, as the volume and complexity of municipal finances grows, municipalities themselves, as well interested parties in the community, are becoming more aware of the importance of having timely access to information on the financial condition and debt position of the municipality. Third, the Ministry of Finance's interest has expanded beyond legal compliance to monitoring the financial condition and indebtedness of municipal governments, for reasons of public sector budget management.

This raises the question of whether the Czech Republic needs new accounting and financial reporting standards, or altered forms of reporting, to serve the new constituencies. The present report recommends certain changes, mostly in financial reporting.

Accrual Reporting

At present, municipalities report financial events primarily on a cash basis. That is, they recognize expenses only as paid for and recognize income only as received. This cash-basis reporting lies at the heart of Czech governmental accounting and should be maintained for legal compliance purposes. Many users of municipal financial reports, however, will look for internationally accepted accrual reporting as more revealing of financial condition. Accrual reporting recognizes expenses incurred during the year, even if the expenses were not paid for, and links the annual financial statement directly with changes in assets and liabilities on the balance sheet.

General Purpose Summary Financial Statements

It would strengthen the usefulness of financial reporting if Czech municipalities developed a more standardized, general purpose summary financial statement that presented basic balance sheet and income statement data and linked the two. This summary statement need be no longer than five or six pages. It would provide the information necessary to determine whether the entity's financial position improved or deteriorated as a result of the year's operations, and provide notes to explain any important changes in the municipality's financial position.

The general purpose financial statement should also summarize:

- Revenues and expenditures over the three prior years
- Revenues and expenditures as projected for the subsequent five year period

To keep from making unnecessary changes that produce little benefit, a summary financial statement of this kind would be prepared only by municipalities which issue bonds or borrow from domestic or foreign banks. A summary financial statement might also be prepared by municipalities that exceed a certain threshold based on population, size of budgets, size of state subsidies, or the like. These thresholds can be determined at a later date.

Service Cost Information

Financial statements potentially can provide much of the information that municipal authorities need to assess the efficiency of local service delivery, or that outside observers need in order to compare the costs of service delivery in one municipality with costs in another. They then become a fundamental management tool. Czech financial reports presently do not provide this kind of information. This report recommends that the Union of Towns and Communities encourage municipalities to experiment with such service cost reporting, either as part of a general-purpose financial report or separately.

Similarly, financial statements and balance sheets can and should be used to report upon the condition of municipal infrastructure facilities and the backlog of capital investment needs. Financial reports prepared on an accrual basis must examine the condition, serviceability, value, and depreciation of the municipality's capital assets. Full reporting on these questions can become a costly and complex endeavor. Therefore, it is appropriate to encourage municipalities to experiment with initial steps in this direction.

AUDITING STANDARDS

Historically, audits of municipal financial statements in the Czech Republic have been conducted by the District Office of the Ministry of Finance under their "Review" procedures. The past few years have witnessed emergence of the independent certified public accountant's audit. Only two (2) percent of all municipal audits for the year ending December 31, 1996 were performed by a certified public accountant firm, but these included many of the larger municipalities.

With the advent of the municipal bond market, audits of municipal financial statements have received closer scrutiny by the Ministry of Finance. In accordance with the provisions of the Act on Bonds, any issuer is required when submitting an application to the Ministry of Finance for permission to issue a bond to attach the previous year's financial statements including the audit report by an independent Certified Public Accountant. A review performed by the District Office is not an acceptable substitute.

The 1992 law on auditing stipulates that the Chamber of Auditors has the domain to establish auditing standards for municipalities. The Chamber is working closely with the Ministry of Finance to develop legislation to set new guidelines and criteria for municipal audits. These procedures have been submitted to the Ministry of Finance for review.

Until now, efforts to expand the use of audits by independent Certified Public Accountants have been focused solely on municipalities issuing bonds. It is recommended that the Czech Republic extend the requirement of an independent external audit to municipalities that borrow from commercial banks or that exceed a certain threshold based on population, size of budgets, or size of state subsidies. District Office audits can determine legal compliance in municipal financial management, but the District Offices do not have the capacity to ascertain whether financial events affecting the municipality have been fairly and accurately reported.

NEXT STEPS

The above recommendations—and others suggested throughout the report—are not simple to implement. The municipalities of the Czech Republic will need assistance to implement accrual based reporting, general purpose financial statements, or service cost reporting; and will need encouragement to adopt independent auditing.

Some of these changes, such as new auditing standards, may be mandated by the Ministry of Finance, or prescribed in law, because of their importance to financial oversight of the municipal sector. In other areas, such as the publication of general purpose summary financial statements, it is appropriate for the Union of Towns and Communities (UTC) to take the lead by encouraging voluntary experimentation, or by preparing model reporting formats that municipalities can voluntarily adopt. More informative and better prepared financial reports should give municipalities better access to capital markets and better control over their financial management. The UTC could accelerate voluntary adoption of new reporting formats by awarding certificates of merit to municipalities that meet certain basic standards. The Government Finance Officers Association in the United States has effectively promoted better municipal financial reporting by developing model reporting formats and awarding certificates of merit to municipalities that meet its reporting standards.

MUNICIPAL ACCOUNTING, REPORTING AND AUDITING

STANDARDS AND CURRENT PRACTICE IN THE CZECH REPUBLIC

STANDARDS FOR MUNICIPAL ACCOUNTING AND FINANCIAL REPORTING

The Process for Setting Standards

Internationally, accounting and financial reporting standards often are established by independent standards-setting authorities or boards. In the United States, for example, the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB) establish the accounting and financial reporting standards for the private and public sectors, respectively. The GASB specifically establishes standards for state and local governments, analogous to the municipalities of the Czech Republic. Internationally, the international accounting standards (IAS) reflect professionally accepted accounting and financial reporting practices. In addition there are international auditing standards for the audit industry.

In Europe, there is greater reliance on laws to establish accounting and reporting standards. The European Union Directives, for example, mandate the use of certain accounting and financial reporting principles. Countries which have been admitted to the European Union must then incorporate these principles into law. The standards themselves reflect guidance from professional associations (see Annex A).

European Union Directives do not establish any mandatory accounting or financial reporting standards for governments. They apply only to the private sector and to enterprises. Each national government is free to draw upon the accounting principles as it sees fit in establishing municipal accounting and reporting standards.

In the Czech Republic, there does not exist an independent standards setting body such as the FASB or the GASB. The accounting and financial reporting framework and principles are established in law. Essentially, there is one predominant user of municipal financial statements, the Ministry of Finance. Financial statements must satisfy the legal compliance requirement set by law as interpreted by the Ministry of Finance. The statements, however, also are used by financial markets and by the public at large.

Development of Standards in the Czech Republic

In the Czech Republic, in addition to the relevant laws, the Ministry of Finance promulgates accounting rules and bookkeeping regulations. MOF rules cover the preparation, submission and approval of municipal financial reports.

The accounting system as a whole covers budgeting, statistical information, and accounting documentation. It consists of:

- Charts of accounts
- Accounting procedures
- Financial statements (balance sheet and profit and loss)

Until the end of central planning, Czech accounting concepts blended government and company accounting into one system. The 1989 Government Decree “On Information Systems of Enterprises” and the 1990 Federal Ministry of Finance Decree “On Accounting” introduced greater cost accounting concepts for enterprises and stimulated the use of computerized accounting in the country. The basic principles of the Fourth and Seventh EU Directives were incorporated into this law, which changed substantially the accounting practices in the country for the private sector, particularly as concerns valuation methods and the preparation, publication and auditing of financial statements.

Very little attention was given to municipal accounting and reporting standards until the Law on Municipalities of 1991. The new accounting concepts were aimed primarily at businesses, banks, and other nongovernmental entities. The 1991 Law on Municipalities required that each municipality have an annual audit performed of its financial statements by the District Office of the Ministry of Finance or an independent certified public accountant audit firm. In addition, the Budgetary Rules Law for preparing budgets applied to all state ministries and municipal governments. A by-law connected to the Budgetary Rules Law provides specific guidance as to how to use state budget resources.

The source of accounting standards for municipalities in the Czech Republic historically has been, and is, the law. The accounting system for municipalities is used to demonstrate compliance with legally prescribed financial matters.

European Union Directives

The content of European Union directives in the accounting field and in company law is discussed in Annex A. The directives do not specifically apply to governments. However, governments can conform their accounts to the principles embodied in the Directives, where relevant, at their discretion. The full title of EU Directives is “Company Law Directives,” indicating their intended application to the private sector.

Compliance with EU Directives in the Czech Republic

The Czech accounting and financial reporting system has been changing to conform with a market driven economy, and to incorporate the principles of accounting from the European Union. The EU Directives applicable to financial accounting and reporting are

the Fourth Company Law Directive of July 25, 1978 and the Seventh Company Law Directive of June 13, 1983 (see Annex A).

The principal milestones in adjusting Czech private-sector accounting and financing reporting standards to the EU standards include:

- The Commercial Code which provides for:
 - Bookkeeping requirements for double and single entry accounting
 - The establishment of the calendar year as the fiscal year
 - The requirement to audit the financial statements of entrepreneurs and other accounting entity types
 - For entrepreneurs, to publish financial statements
 - For entrepreneurs, to maintain their accounting records in conformance with the Law on Accounting
- The 1991 Law on Accounting which provides the basis for the Czech Republic accounting system and establishes:
 - The requirement that all accounting entities, including governments, maintain accounting records.
 - The principles of accounting, the books of account, files and other documents. The books of account consist of a general ledger with entries in a systematic order, a book of analytical records with specific detail supporting the general ledger, and a day-book with entries in chronological order.
 - A double-entry system of accounting
 - Accounting procedures to produce required financial statements and other data to be reported
 - Required financial statements, the balance sheet and profit and loss statement and appendices
 - Consolidated statements for entrepreneurs and other entities
 - The annual report
 - The scope of the audit requirement and the exclusion of small trading companies from the audit requirement
 - Methods to value properties and liabilities, including foreign currency

- Methods to value inventory
- Procedures governing the period for maintaining accounting records
- Sanctions for violations of the Accounting Law

The chart of accounts defines the basic accounting classes and groups of accounts that are to be used in the accounting system. There are different charts of accounts prescribed for different types of entities (e.g., banks, commercial companies, civic associations). The Ministry of Finance has promulgated a special chart of accounts for municipalities. In addition, the Ministry of Finance has issued related procedures concerning the balance sheet and profit and loss (or financial) statement for different types of entities.

The accounting procedures promulgated by the Ministry of Finance have embodied the principles of the Fourth Directive for most sectors of the economy. Examples of such provisions incorporated by the Ministry of Finance for the private sector include:

- Methods of valuing property
- Foreign currency exchange rules
- Valuation of fixed assets
- Matching revenues and expenses
- Amortization of tangible assets, except stocks
- Current and deferred taxes
- Long-term accounts receivables provide an allowance
- The timing differences between tax and accounting depreciation
- Foreign currency exchange rates should be recognized periodically, not to wait until the security transaction is completed
- Asset reductions should be expressed through allowances and not asset write-downs

The country has adopted the European Directives for accounting and financial reporting methodologies, has a certificate from the European Union to this effect, and has applied these directives to all organizations except governments. Best-practice municipal accounting follows the procedures established by law and by the Ministry of Finance for companies, when these are applicable—e.g., for valuing foreign currency debt, or valuing physical property owned by the municipality. However, the EU Directives are not binding on local governments.

Municipal Sector Accounting

The budget format and chart of accounts for municipalities have changed substantially over the past few years to move closer to Western practice. However, substantial gaps remain between Czech standards and international accounting standards.

Czech Accounting Practice and Standards

Municipal budgets are prepared annually. The budget combines all operating and capital items within a single budget, grouped by prescribed budget classifications. Actual receipts for revenue and disbursements also are accounted for within a “single fund,” the chart of accounts, using prescribed accounting classifications for different kinds of revenue and expense. However, the classifications prescribed for budget preparation do not coincide with the classifications prescribed for accounting for actual receipts and disbursements, making it difficult to track or analyze expenditures by budget function.

All, municipalities are required to maintain expense detail accounts. Actual revenue and expenditure transactions are recorded based on the classifications prescribed in the chart of accounts, with corresponding balance sheet entries. Periodically, (monthly, quarterly, semi-annually, or annually) the municipality completes the required reporting forms and submits them to the District Office of the Ministry of Finance for review and further processing.

Municipal services in the Czech Republic are provided by institutions or enterprises which are classified as budgetary or contributory organizations within the municipal budget. Budgetary organizations are accounted for on a cash basis; that is, revenues are recorded when cash is received and expenditures are recorded when cash is disbursed. The accounting for contributory organizations generally follows the accrual basis. Only the net subsidy to such organizations or the net revenue from them appears in the municipal budget.

For analytical and financial monitoring purposes, the combined budget of Czech municipalities can be disaggregated and recombined in various ways. For example, the computerized budget model prepared by the Urban Institute in collaboration with the Union of Towns and Communities constructs an “operating budget” composed on the revenue side of operating or recurring revenues and on the expenditure side of operating expenses. It then calculates an operating surplus (available to help finance capital expenditures or pay debt service on new borrowing) or operating deficit. The elements that comprise “operating revenues” and “operating expenses” have to be reconstructed from currently reported budget and chart-of-accounts categories. Czech municipalities do not report, and most do not prepare, separate operating and capital budgets.

In 1996, municipal budget categories were re-organized to allow the Ministry of Finance to monitor more closely municipal deficits and municipal borrowing. The new budget classification took effect in 1997. One shift was to re-classify “transfers from past (accumulated) surplus” to the category “other sources of revenue” along with municipal borrowing and other one-time revenues. The purpose of this change was to make clear the correspondence between current-year budget expenditures and current-year revenues.

The re-classification was accompanied by instructions from the Ministry of Finance that municipal budgets should show a balance between current year revenues and current year expenditures, eliminating the use of debt and transfers of surplus for financing operating expenditures. There have been proposals within the Ministry of Finance to formally separate the “operating budget” in municipal budgeting and accounting from the “capital budget.”

FINANCIAL REPORTING

Disclosure Requirements

Czech municipalities are required to disclose to the residents of the community the draft budget and the final account for the past calendar year at least 15 days before they are to be reviewed by the Municipal Assembly. Residents may provide their comments on the draft budget and final account for the past year either in writing during the appointed period or verbally at the meeting of the Municipal Assembly. There are no specific requirements as to where or how these documents should be publicized. Disclosure focuses substantially on the fulfillment of budgeted revenues and expenditures for a fiscal year period.

Municipal Financial Statements

The following table shows the required forms, report description and frequency of municipal financial reports in the Czech Republic today. All reports are submitted to the Ministry of Finance. They are not available to the public. The financial statements contain much detail in order to demonstrate legal compliance or “fulfillment”—i.e., that revenues were generated in legally appropriate ways, that funds were expended in the manner prescribed by law, and to compare actual results with budgeted results. For example, the Statement on Budget Performance of Municipalities and District Offices (UC 1-12) and the Balance Sheet (UC ROPO 3-02) contain ten (10) and four (4) pages of information, respectively. While this detail is important, it provides too much information for general financial statement purposes. The current level of detail for legal compliance reporting should be maintained, but it would be useful to summarize this information in more accessible form for annual financial statement purposes. The summary reports should be routinely available to financial markets and the public.

Form	Description	Frequency
Form UC 1-12	Statement on Budget Performance of Municipalities and District Offices	Monthly
Form UC R0 2-04	Report on Performance of Budgetary Organizations, Income and Expenditures	Quarterly
Form UC ROPO 3-02	Balance Sheet	Semi-annually
Form UC ROPO 4-02	Profit and Loss Accounts, all contributory organizations which are economic activities	Semi-annually
Form MPO UC 5-01	Annual Report of the Economic Performance of Small Contributory Organizations	Annually
Form UC 6-01	Annual Overview of Assets and Liabilities for Small Cities	Annually

Filing of Financial Statements

Enterprises must file their financial statements with the Ministry of Finance. The statements are filed with the tax collection office with two copies of the tax return and the statistical data. For municipalities, the financial statements are filed with the District office of the Ministry of Finance.

Municipal Bond Prospectus

Since 1992, Czech municipalities have issued nineteen (19) bonds totaling about 12 billion crowns. For each issue a prospectus was prepared by the municipality. This prospectus contained far more information than the legal reporting requirements yet focused substantially on the fulfillment of revenues and expenditures over the past three years, a projection of revenues and expenditures for the next five years, and a summarized balance sheet for the latest year. Again the focus of this type of disclosure is revenue and expenditure performance. The following are the major sections of a recent bond prospectus with a further breakdown showing the type of financial information provided:

- Introductory Provisions
- Characteristic and Terms of Issuance of Securities
- Basic Data of the Issuer
- Information on Municipal Activities

- Information about Financial Status
 - Economic Results of the Current Year (UC 1-12 Summarized)
 - Yearly Balances of Accounts for Previous Three Years (UC 1-12 Summarized)
 - Forecast of Revenues and Expenditures for the Next Five Years
 - Balance Sheet of the Current Year (UC ROPO 3-02 Summarized)
 - Previous Bond Issues
 - Bank and Other Credits Received
 - Other Liabilities
 - Unsettled Credits
 - Payment Insolvencies
 - Reserve Fund Balance
- Management and Administration Bodies
- Closing Provisions

Credit Rating Agency Reviews

Credit rating agencies and underwriters are one important example of the new generation of users of municipal financial statements. Standard & Poors has rated two of the largest Czech cities: Prague and Ostrava, for international bond issues. The city of Prague issued \$250 million US of debt in 1994. Ostrava issued 75 million (German Marks) of debt in 1996. Based on discussions with the city of Prague, the underwriting bank (Nomura Bank--London Stock Exchange) requested the following information from the city in anticipation of its 1994 bond issue:

- Past financial statements for CY 1992 and CY 1993
- Projected financial statements (financial means) for CY 1994 - CY 2000
- Credit and debit balance analysis
- List of projects for the use of funds and expected results

Standard & Poors international division does not have the luxury of reviewing audited financial statements in Eastern Europe in general. The audit profession is relatively new in Eastern Europe. For example, while the city of Prague had completed the required reports (UC 1-12, 2-04, 3-02), these reports had not been audited by an independent certified public accountant firm nor reviewed by a District Office of the Ministry of Finance at the time of the bond issue. Thus, Standard & Poors takes information provided by the municipality based on a questionnaire, a more detailed questionnaire in the case of a first rating.

One important criterion is operating surplus, the difference between operating expenditures and operating revenues. Standard & Poors typically separates gross or total surplus according to operating and capital in the same manner as the computerized Financial Assessment Model developed by the Urban Institute and Union of Towns and Communities. Standard & Poors begins with total budgetary surplus but needs to see how the entity is functioning from both the operating and capital view.

Audited statements notwithstanding, Standard & Poors does its own analysis. Information presented to Standard & Poors by the issuer is strengthened by Standard & Poors internal analysis. It examines the:

- Economy of the region or local area including economic structure and growth potential, revenue from taxes and fees, regional comparisons to national average, unemployment figures, and the like.
- System or regulatory structure within which local governments work to determine how revenues and expenditures are determined by the system.
- Matching of revenues and expenditures. This criterion is not limited to local revenues but also state mandates and corresponding revenues to meet these mandates. A basic question is, can the national government download services to local governments without revenue matching? Are there laws in place to require revenue and expenditure matching? In the Czech Republic, the national government cannot transfer services to the local government without corresponding revenues. While this system is in place in the Czech Republic, it is not legally structured. The Czech national government seems to transfer revenues commensurate with the transfer of service responsibilities, but this is not a legally required practice.
- Financial performance focusing on operating surplus and capital needs, capital spending. This criterion looks at how well government has performed from an operating viewpoint. Some issues that Standard & Poors looks at include:
 - Budget vs. actual
 - Forecast of financial capability. Standard & Poors uses historical trends and trends in budget to actual over a five (5) year period
 - Debt outstanding
 - Ability to repay debt
 - Ratios to assess level of debt based on such items as per capita, relative to operating revenues, economic growth, and the like.

Credit ratings and rating reports prepared by Standard & Poors are released to the

public only with the approval of the municipality. However, if the municipality issues a bond and uses the credit rating, the report must be made public.

ANALYSIS OF MUNICIPAL FINANCIAL REPORTING IN THE CZECH REPUBLIC

Comparison with GASB Financial Reporting Objectives

There are three prominent objectives of financial reporting as promulgated by the Governmental Accounting Standards Board. These provide a good basis on which to evaluate current municipal financial reporting in the Czech Republic.

First, financial reporting should assist in fulfilling government's duty to be publicly accountable and should enable users to assess that accountability. This means that financial reporting should provide information to determine whether current year revenues were sufficient to pay for current year services. Specifically, financial reporting should demonstrate whether resources were obtained and used in accordance with the entity's legally adopted budget, should demonstrate compliance with other finance-related legal or contractual requirements, and should provide information to assist users in assessing the service efforts, costs and accomplishments.

In the Czech Republic, municipal financial reporting does substantially meet this objective. Financial reporting focuses on the fulfillment of revenues and expenditures for the fiscal year, which allows users to determine whether current year revenues are sufficient to meet current year expenditures and whether the resources are obtained and used consistent with the budget. The fact that municipal budgets are revised periodically during the fiscal year underlines this fundamental concept that the revenues and expenditures must be matched and final budgets fulfilled. However, the financial reports do not allow users to assess the service efforts, costs and accomplishments. There are no performance measures such as unit service delivery costs, service outputs, or service and investment backlogs.

Second, financial reporting should assist users in evaluating the operating results of the government entity for the year. This means that financial reporting should provide information about the sources and uses of financial resources and about how the governmental entity financed its activities and met its cash requirements. Within this objective, financial reporting should also provide information necessary to determine whether the entity's financial position improved or deteriorated as a result of the year's operations.

In the Czech Republic, municipal financial reporting partially meets this objective. Financial reporting focuses on the sources and uses of financial resources, and how the

entity financed its activities and met its cash requirements. However, by focusing on the fulfillment of revenues and expenditures, current financial reporting does not directly provide the information necessary to determine whether the entity's financial position improved or deteriorated as a result of the year's operations. This would require explicitly combining the results of operations (fulfillment of revenues and expenditures) with the end-of-year financial position (balance sheet).

The failure to use accrual accounting in the financial reports can obscure financial obligations the municipality may have incurred during the year but not paid for. Further, the financial reports do not make significant use of notes to explain major changes in financial position.

Third, financial reporting should assist users in assessing the level of services that can be provided by the governmental entity and its ability to meet its obligations as they become due. This means that financial reporting should provide information about the financial position and condition of a governmental entity, about a governmental entity's physical and other nonfinancial resources which have useful lives that extend beyond the current year, including information that can be used to assess the service potential of those resources. Reporting should disclose legal or contractual restrictions on resources and risks of potential loss of resources.

In the Czech Republic, municipal financial reporting partially meets this objective. The balance sheet presents the financial position of a municipality at a point in time, typically December 31, the end of a fiscal year. However, the balance sheet does not always present fairly the municipality's financial position. Three examples will illustrate this point.

- **Fixed assets.** These must be accounted for and presented on the balance sheet. With contributory organizations and other economic agents, the fixed assets are to be depreciated. However, the valuation, recording and reporting of fixed assets is a concern currently. Municipalities have received a significant number of fixed assets from the state for which the municipality is now responsible. The municipality needs to value, record, and report the fixed assets and changes in their value. Due to the magnitude of recently acquired assets, municipalities have not kept pace with the valuation and recording of fixed assets. Thus the balance sheet understates this aspect of their financial position.
- **Accounts payable.** In best practice, governments record accounts payable when a good or service is received, regardless of the amount of cash the government has to pay bills. This is the accrual method of reporting accounts payable. A liability is incurred and an expense generated when the good or

service is received. In the Czech Republic, some municipal governments limit the liability recorded to the amount of cash available to pay for it and do not record the full liability. Thus both the balance sheet and annual financial statements may understate the liabilities of a municipality.

- **Accounts receivable.** Under GASB, governments record accounts receivables when a bill is issued based on the full value of the amount owed. An allowance (sometimes called a provision) is typically recorded to reduce the accounts receivable by an amount deemed to be bad debts. This determination is usually based on history. In the Czech Republic, an allowance or a provision for bad debts is generally not established on the balance sheet. Thus the assets of the municipality are generally overstated for accounts receivable on the balance sheet.

In sum, Czech municipal reporting does not lead to accurate estimates of accounts payable or accounts receivable. Nor is the value of fixed assets, their condition, or remaining useful life commonly reported. Moreover, the financial reports provided to the Ministry of Finance are not available to financial markets or the public at large. This lack of general disclosure in the system has impeded the development of third-party analyses of municipal financial condition.

Credit Rating Agency Analysis

Municipal financial reports should be immediately useful to financial markets and credit-rating agencies. Municipalities issuing bonds or seeking credit ratings do provide the underwriters or the credit-rating agency with financial reports. Typically, banks making loans to municipalities also require full access to financial statements. The following section presents a summary of Standard & Poors assessment of the utility of financial reporting in the Czech Republic. It is based on discussions with a representative from Standard & Poors, and is presented in the form of Questions and Answers.

Q: What is the relevance of the financial statements to the credit worthiness of municipalities in the Czech Republic?

A: Standard & Poors would like financial statements. Whether statements exist or not, Standard & Poors issues a questionnaire to the municipality to obtain the data it needs.

Q: What is the relevance of audits of financial statements to the credit worthiness of municipalities in the Czech Republic?

A: Audited statements in Eastern Europe are a new phenomenon. An audited

statement impacts a rating in a positive sense, but not materially. An unaudited statement would not negatively impact a rating. Standard & Poors would gather data anyway, whether an audited statement is issued or not. They would also conduct their own validation of data.

Q: In the absence of audited financial statements, what does Standard & Poors require for information to determine the credit worthiness of municipalities in the Czech Republic?

A: Standard & Poors issues a questionnaire which covers a broad spectrum of data. See criteria below.

Q: How does Standard & Poors receive that information?

A: The information is submitted by the entity requesting a rating, in response to the questionnaire.

Q: How does Standard & Poors validate that information?

A: Validation is unclear at this juncture.

Q: What recommendations can be suggested to improve the credit information produced in the financial statements or the audits of financial statements for municipalities in the Czech Republic?

A: Recommendations are unclear at this juncture.

Q: Whose credit is rated, the municipality or the state?

A: That of the municipality. There are no formal or informal guarantees by the central government to repay debt of localities. What the market perceives is a different matter. Thus Standard & Poors rates the municipalities and believes the state has no obligation to bail out the municipalities if they default on a bond.

In its credit reports, Standard & Poors referred to Prague's and Ostrava's robust economic and revenue growth, demonstrated prudent fiscal management, and low debt levels to balance large capital expenditure needs. As a result, Standard & Poors issued an investment grade foreign currency rating of "A" with a stable outlook for Prague and Ostrava. Standard & Poors plans to establishing varying credit differentials within the system where fiscal prudence will be a key determinant of credit quality of individual municipalities. Standard & Poors will base their credit differentials on the administrative and financial structure as well as local borrowing trends.

Conclusions

Are new accounting and financial reporting standards needed for the municipalities of the Czech Republic? European Union Directives do not mandate accounting or financial reporting requirements for local governments. Thus, the answer depends on the utility that different forms of accounting or financial reporting would have to financial markets, the national government, and the public at large.

A change in accounting standards would require a massive overhaul of current procedures for recording financial events, and major changes in the standard reporting instruments. This report does not recommend attempting such sweeping changes. It does recommend modifications in the *reporting* of municipal finances.

Traditionally, the primary user of municipal financial statements in the Czech Republic has been the Ministry of Finance. Existing financial statements demonstrate compliance with legal provisions and with officially adopted local budgets.

However, the users of municipal financial statements in the Czech Republic are changing. They are changing in four significant ways. First, a number of municipalities are issuing bonds or borrowing funds on the international market. International lenders and investors do not necessarily understand Czech Republic law. Thus there is an international lender and investor view to the financial statements which must be taken into account.

Second, domestic banks lend to municipalities. Collateral, when required, is generally secured with municipally owned assets such as stocks, land or other property. Yet other than contributory or economic agents, fixed asset records are generally not updated. Municipalities often do not properly maintain or report updated fixed asset records. Consequently, domestic banks may require information that goes beyond that found in current financial reporting. Third, as more municipalities issue bonds, manage larger amounts of money, and provide more complex services, it is in their best interest to establish reporting that goes beyond legal compliance. Financial reports should also help municipal authorities manage public services more efficiently and should allow citizens to judge the efficiency of local service delivery.

Finally, the Ministry of Finance needs additional information in order to monitor aggregate municipal-sector deficits and municipal indebtedness as part of its macroeconomic management. This role has become especially critical during the current public sector retrenchment.

Recommendations

Accrual Reporting

It is recommended that Czech municipalities prepare financial reports consistent with legal compliance *and* accrual reporting. This recommendation would necessitate an education process explaining the importance of accurate balance sheet reporting and the differences between legal compliance and accrual reporting. International users, in particular, are likely to demand accrual reporting in order to assess the local financial position. Financial reports using the accrual basis of reporting, combined with the current legal compliance reporting, would present relevant information to all users of financial statements.

This is a *reporting* recommendation, not a change in budgeting or basic accounting procedures. Legal compliance reporting would be maintained. Accrual-based information would be prepared by adjusting the standard Ministry of Finance reports to take account of additional accrued liabilities or assets. This recommendation would be applicable to municipalities which exceed a certain threshold based on population, size of budgets, size of state subsidies, and the like. These thresholds can be determined at a later date. The recommendation also would apply to any municipality which issues bonds or borrows money beyond a threshold level from a domestic bank.

General Purpose Financial Statements

The municipalities of the Czech Republic should develop a more standardized general purpose financial statement presenting basic balance sheet and income statement data. This summary financial statement should be no more than two pages each for the income statement and balance sheet, with perhaps a page of explanatory notes and a page summarizing historical revenue and expenditure trends. General purpose financial statements are similar to the current financial statements of the municipalities of the Czech Republic in that they report information consistent with a balance sheet, income statement, and budget. General purpose financial statements are different however in one important element; they present data in a more summary fashion. Summary reports make financial information more accessible both to the general population and to credit markets.

Price Waterhouse, the audit firm which is auditing the financial statements of the city of Prague, has drafted an audit report which provides a more summary level of information for the financial statements. Further, Price Waterhouse has also developed a set of note disclosures which are an integral part of the city's financial statements. We have not been able to review the format of the general purpose financial statements nor the note disclosures as the draft audit report is confidential as of this writing. Nonetheless, the concept of such a report is intriguing and should be reviewed once released. This type of disclosure has the potential to provide more information in a condensed fashion than the current financial reports.

The summary financial statements should also include a reconciliation of cash flows with the accrual accounting summary. At present, municipalities often adopt a hybrid form of reporting that makes it difficult to disentangle either pure cash flows or accrual obligations. In addition, municipal financial statements should directly provide information necessary to determine whether the entity's financial position improved or deteriorated as a result of the year's operations. To do this, the financial statement should expressly link the results of operations with the financial position as reported in the balance sheet.

Disclosure

At present, the financial reports submitted to the Ministry of Finance are treated as confidential documents. They are not available to financial markets, third-party analysts, or the public at large. Municipalities may release their own reports (for example, to underwriters or credit-rating agencies) when it is in their interest to do so, and are required to release certain information in connection with bond issues. The lack of general disclosure, however, has made it impossible to carry out comparative studies of municipal financial condition. It has impeded understanding of both the financial situation of the municipal sector in the aggregate, and the warning signs of potential financial crises in particular municipalities. Summary, general purpose financial statements should be fully disclosed and made part of the public record.

It is recommended that municipalities issuing municipal bonds, receiving bank loans, or which are above certain thresholds of population, budget size or meet other criteria, routinely publish a general purpose financial statement with note disclosures (see above), along with revenue and expenditure summaries for the three prior years, revenue and expenditure projections for the subsequent five year period, and explanations for negative operating results.

Separate Capital and Operating Budgets

Czech municipalities prepare their budgets and financial reports according to a single fund format that combines operating and capital expenditures as well as operating and capital revenues. This accounting format makes the definition of a "deficit" in municipal accounts somewhat arbitrary. On a cash accounting basis, it is impossible to have a deficit in the single fund. All expenditures must be paid for in cash, and the cash must come from some source on the revenue side of the budget.

In the Czech Republic, municipalities expend an unusually high share of their total budgets on capital investment. Investment may be financed from the surplus of operating revenues over operating expenditures in the current-account budget, from the municipality's cash holdings, or from "capital" revenues such as borrowing, or the sale of

assets. However, the proceeds from borrowing, asset sales, and drawdown of cash reserves can also be used to finance current operating deficits, obscuring an underlying budgetary imbalance. For this reason, in assessing a municipality's creditworthiness or financial position, it becomes important to distinguish whether certain types of revenues are used to pay for operating expenses or capital investment.

Effective in 1997, the Ministry of Finance introduced new budget classification rules intended to clarify the financing of operating and capital expenditures. As long as the single-fund accounting structure is maintained, however, the distinction between operating and capital elements will remain somewhat arbitrary.¹ It would be preferable to have formally separate "operating budgets" and "capital budgets." The Ministry of Finance has stated that it intends to move in this direction.

¹ The Ministry of Finance's classification, for example, treats drawdowns of a municipality's cash holdings, when used to pay for operating expenses, as equivalent to "deficit financing." Municipalities using this or other types of deficit financing, like borrowing, to pay for operating expenditures are to be penalized by reduction in central government subsidies.

Mandatory or Voluntary Change?

Some of the recommendations made here—such as full disclosure of summary financial statements and separation of capital from operating budgets—will require legislative changes or new Ministry of Finance decrees. Most of the modifications, however, will be more effectively introduced on a voluntary basis. The Union of Towns and Communities (UTC) should prepare model examples of summary financial statements. USAID technical assistance could support this effort. In the United States, the Government Finance Officers Association awards special certificates of merit to municipalities that adopt its model format for financial reporting, or which incorporate the basic principles within their own formats. This program has proved very successful in upgrading the quality of municipal financial reporting and in encouraging broader disclosure of financial operations.

Over the intermediate term, more informative financial reporting should improve municipalities' access to credit markets, make it easier for the Ministry of Finance to monitor financial conditions in the municipal sector, and support greater citizen participation in local budget choices. The UTC should take the lead in identifying new reporting standards and move to establish such standards, without waiting for prescriptive instructions from the Ministry of Finance.

Service Cost Reporting

Financial statements potentially can provide much of the information that municipal authorities need to assess the efficiency of local service delivery, or that outside observers need in order to compare the costs of service delivery in one municipality with costs in another. They then become a fundamental management tool. Czech financial reports presently do not provide this kind of information. This report recommends that the Union of Towns and Communities encourage municipalities to experiment with such service cost reporting, either as part of a general-purpose financial report or separately.

Similarly, financial statements and balance sheets can and should be used to comment upon the condition of municipal infrastructure facilities and the backlog of capital investment needs. A financial report and balance sheet prepared on an accrual basis requires coming to terms with the condition, serviceability, value, and depreciation of the municipality's capital assets. Full reporting on these questions can become a costly and complex endeavor. Therefore, it is appropriate to encourage municipalities to experiment with initial steps in this direction.

AUDITING STANDARDS

The Need for Audits

To be useful financial reporting must faithfully represent the financial condition and debt position of municipalities. Auditing is the systematic process of verifying the reliability of financial reports and the appropriateness of underlying financial activities. Public accountants or external auditors examine financial statements through audits in order to be able to express an opinion as to whether the financial statements present a true and fair view of the financial position (balance sheet) and results of operations (income statement), and whether financial activities have been carried out in compliance with the law. External auditors generally evaluate financial statements from the point of view of external financial stakeholders such as creditors and investors. District office reviews generally evaluate the financial statements from the legal compliance viewpoint.

As long as municipal activities are confined within one country, auditing philosophies and techniques can be determined by national bodies, such as the Ministry of Finance, building on the country's own traditions. For investors in international capital markets, however, the audit report and the quality of the audit work are important to the credibility of financial statements. Typically, investors in foreign capital markets look to international accounting, auditing and financial reporting standards in order to better understand financial reporting results.

Czech Practice: District Audits

Czech auditing still emphasizes legal compliance. The principal auditing unit is the District Office of the Ministry of Finance. Czech municipalities may request an audit from the corresponding District Office. The audit review begins shortly after the accounting records are closed in January. By March the district will issue its draft report and discuss the report with municipal officials. The municipality then issues a letter of explanation within 7 to 10 days and typically makes the adjustments or corrections by June 30. The report is discussed with the City Council and the City Assembly which approves the report. The district office report generally, but not always, contains the following sections:

- Budget, budget adjustments and performance
- Accounting observations on the chart of accounts and reviews of cash balances, receipts and other items such as business trips
- Local and administrative fees
- Assets and inventory check
- Special reviews such as the personnel classification system or accounting for administrative flats owned by the city
- Conclusion

— Final statement

The conclusion and final statement of the District Office report is similar to an “audit opinion” relative to compliance with law. The conclusion section describes in detail any violations of law, while the final statement cites the specific statutes in question. The District Office has no legal authority to recommend what the municipality should do to improve its operating results or financial position.

In carrying out its audit, the District Office typically examines whether final expenditures correspond to the approved local budget, as formally modified throughout the year; whether State subsidies were spent as prescribed by law; whether the budget and financial reports follow the format prescribed by the Ministry of Finance; whether financial relations between the municipality and budgetary and contributory organizations are reported in the form required by law; and whether the data reported are accurate.

The Independent Certified Public Accountant Audit

Prior to 1989 in the Czech Republic, the balance sheet and profit and loss statements of all enterprises were approved by the Ministry of Finance or its designees. It was not until 1989 and 1990 that independent auditing of financial statements were required of certain (not all) enterprises. Subsequently, in 1992 The Law on Auditors and the Chamber of Auditors was passed. It required audits for private sector entities as follows:

- All stock companies
- Trade companies whose turnover exceeds 40,000 Kc or where net assets exceed 20,000 Kc.

The 1992 Law on Auditors and the Chamber of Auditors established:

- Auditor qualification requirements
- Scope of the auditor’s duties
- Appointment and revocation of auditors
- Assessment of the auditor’s qualification and work.

Pursuant to the law, the Chamber of Auditors was founded in 1993. There are now approximately 1,200 certified auditors and assistant auditors, a number which has doubled since 1993. The Chamber of Auditors provides educational training, prepares and administers the auditor’s examination, and prepares auditing standards. By 1997, the Chamber had incorporated 17 of the 51 international auditing standards in Czech private-sector audit standards.

The Chamber has also drafted auditing guidelines for municipalities. These have been presented to the Ministry of Finance where they are now under review. Currently, there are no auditing standards to guide independent certified public accountant audits of municipalities in the Czech Republic.

Czech municipalities may request an audit from an independent certified public accountant firm instead of the District Office. The independent certified public accountant firm provides this service for a fee. A municipality must select the auditor through competitive bidding if the fee will exceed 100,000 Kc. Bids must be received from at least three firms. In order to bid, the audit firm generally submits:

- Certification of registration with the Chamber of Auditors
- Auditor license with the Chamber of Auditors
- Listing of clients representing qualifications to do the work
- Fee
- Audit work plan
- Staffing

Because there are no specialized audit procedures for municipalities, firms use the general auditing procedures for businesses, which consist of about 30 guidelines. The objective of the audit is both to satisfy the Ministry of Finance that legal requirements have been met and legal requirements and to verify the municipality's reporting of financial position and results of operations. There is no required format for the audit opinion. The firm audits the UC 1-12, 3-02 and 4-02 reports, corresponding to the income statement, balance sheet, and profit and loss statement of budgetary organizations.

The draft guidelines for municipal audits as prepared by the Chamber of Audits were not available to the author and have not been reviewed as of this writing.

Municipal Audits 1996

Of the 6,225 municipalities in the Czech Republic, 5,603, or 90 percent, were audited for the year ending December 31, 1996. A District Office conducted 5,488, or 98 percent of the audits, while 115, or 2 percent of the audits, were conducted by independent certified public accountants. Most of the municipalities receiving independent audits were of large population size.

Recent Developments

The traditional District Office review plays an important role in Czech municipal finance. The Ministry of Finance would like the District Office review to go beyond legal compliance to provide a review of the true picture of assets and liabilities, but in reality

Districts do not have the resources or the training to examine the economic events which underlie local financial reports. The District's focus is legal compliance. This role should now be balanced with the role of the independent certified public accountant auditor.

With the advent of the municipal bond market, audits of municipal financial statements have received closer scrutiny by the Ministry of Finance. In accordance with the provisions of the Act on Bonds, any issuer when submitting an application to the Ministry of Finance for permission to issue a bond must attach the previous year's financial statements including an audit report by an independent Certified Public Accountant. A review performed by the District Office is not an acceptable substitute.

Recommendations

The standardize municipal auditing practice and make it more relevant to financial markets, we recommend:

- All municipalities must have a legal review conducted by the District Office at least every two years.
- Any municipality which borrows beyond a threshold amount through bank loans or bond issues must have an independent certified public accountant audit.
- The basic items to be addressed in an independent certified public accountant audit should be spelled out by law or by government decree. This should not prevent municipalities from requesting additional auditing information.
- Municipalities which exceed certain thresholds for population, size of budgets, size of subsidies must have an independent certified public accountant audit.

This approach would provide legal compliance review for all Czech municipalities, while verifying that municipal financial reports accurately report underlying economic events for municipalities borrowing on the credit market or having substantial budgets.

ANNEX A

EUROPEAN UNION DIRECTIVES

The coordinating organization for the accountancy profession in Europe is the *Federation des Experts Comptables Europeens*, also known as FEE, which began formal operations in 1987. FEE was created by the consolidation of the *Union Europeene des Experts Comptables, Economiques et Financiers* (founded in 1951) and the *Group d'Etudes des Experts Comptables de la CEE* (founded in 1961). They were instrumental in developing European accounting but are not considered to be standards-setting bodies for European accounting. FEE's objectives are in part to work generally toward the enhancement and harmonization of the accountancy practice in the broadest sense; to promote cooperation among the professional accountancy bodies in Europe in relation to issues of common interest; to represent the European accountancy profession at the international level; and to be the sole consultative organization of the European accountancy profession in relation to the European Community authorities. As such these groups helped to write the European Directives which support the goals of the European Union.

The goal of the European Union is: "by establishing a common market and an economic and monetary union and by implementing the common policies or activities referred to in the Treaty, to promote throughout the Community a harmonious and balanced development of economic activities, sustainable and non-inflationary growth respecting the environment, a high convergence of economic performance, a high level of employment and of social protection, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States" (European Community Treaty (ETC) also called Treaty of Rome of March 25, 1957).

The issue is how does the European Union create a harmonized environment in order to promote an internal, competitive market when the economy of Europe, particularly Eastern Europe, is changing so dramatically, and each Member or potential Member has significantly different laws. How does a company which wishes to do business in Europe or establish a location within one of the European countries, or several European countries, know the rules under which the company must operate? How does the company register? What about stock? How will the company maintain its accounting records? How will the company report its financial results? What are the audit requirements? What about mergers? These are some of the issues which need to be harmonized within the European Community.

Implementing a harmonized European Community can take many forms, among which are voluntary compliance, regulations and directives. Voluntary harmonization would be difficult with a significant number of viewpoints, requiring eventually some form of rules. A regulation, is binding in its entirety and directly applicable in all Member States. A

directive is binding, but only as to the objective to be achieved, upon each Member State to which it is addressed. The choice of form and methods to meet the objective is left to the national authorities. The European Directives are a subject of this report.

Although regulations can be implemented, directives are the predominant means of legal harmonization because directives offer more protection for the sovereignty of the European Union Member States. A directive is a flexible instrument which allows the achievement of a common objective without necessarily imposing uniform rules in all circumstances. Once agreed (a process that has taken over 20 years for some Directives) a Directive requires all members to introduce legislation to implement the Directive. The directives have represented a gradual movement, starting with registration requirements and then proceeding to capital maintenance, accounting and so on, to the more complicated issues like takeovers, cross-border mergers and corporate governance.

There are 13 numbered directives (not all passed) regarding company law. The Sixth Directive amends the Third Directive, which results in 12 basic directives. These directives apply to “public” and “private” companies. “Public” companies are those authorized by law to issue freely negotiable shares. “Private” companies are restrained by law from allowing their shares to be freely traded on securities markets. Harmonization is intended to apply to public and private companies. The Directives are not intended to be directly applicable to governments. However, governments may use them as guidance if they wish, where the subject matter is relevant.

The basic directives on company law are as follows :

- First Directive of March 9, 1968 on disclosure, validity of obligations and nullity of limited liability companies.
- Second Directive of December 13, 1976 on the formation and capitalization of public and large companies, and the maintenance and alteration of their capital.
- Third Directive of October 9, 1978 concerning mergers between publicly-held companies, establishing guidelines and providing shareholder safeguards.
- Fourth Directive of July 25, 1978 provides detailed accounting standards regarding the format, content, valuation methods and reporting requirements of annual reports of certain types of companies, reporting on the true and fair value of the company.
- Amended proposal for a Fifth Directive concerning the structure and administration of public limited companies (not adopted)

- Sixth Directive of December 17, 1982 concerning the division of public limited liability companies, which supplements the Third Directive.
- Seventh Directive of June 13, 1983 on consolidated accounts, establishes guidelines for consolidated statements, which eliminates various inter company accounts between a parent and a subsidiary company.
- Eight Directive of April 10, 1984 on the approval of persons responsible for carrying out the statutory audits of accounting documents.
- Ninth Directive on liability of a parent company for the obligations of a subsidiary company under the parent's control: no proposal yet.
- Proposal for a Tenth Directive of January 8, 1985 concerning cross-border mergers of public limited companies.
- Eleventh Directive of December 21, 1989 concerning disclosure requirements in respect of branches opened in a member state by certain types of company governed by the law of another state.
- Twelfth Directive of December 21, 1989 concerning single-member private limited companies.
- Amended proposal for a thirteenth Directive concerning hostile takeover and other general bids.

With respect to accounting and financial reporting issues, the Fourth and Seventh Directives provide harmonization guidelines to the private sector.

ANNEX B

ACCOUNTING PRINCIPLES

Accounting is a complex subject. It is complex because of two concepts: the measurement focus and the basis of accounting.

MEASUREMENT FOCUS

The measurement focus concerns “what” the financial statements should communicate and “what” the financial statements will measure. Generally there are two types of measurement focus: current financial resources and economic resources.

The current financial resources measurement focus reports current assets and current liabilities. Current assets are those assets which can be converted to cash quickly. Current liabilities are those liabilities which are due in the short term, generally within a year. The difference between the current assets and current liabilities is considered available, spendable financial resources. Funds using this method report revenues and expenditures on their financial statements. This is also known as the funds flow measurement focus.

The economic resources focus, also known as the capital maintenance measurement focus, typically reports all assets and all liabilities on the balance sheet. Both short term and long term assets and liabilities are reported. The difference between all assets and all liabilities is the equity or the capital of the fund. Governments using this measurement focus include all costs of providing services, including depreciation. Funds using this method report revenues and expenses on their financial statements.

In the Czech Republic, the current fund that is used by municipalities corresponds to a current financial resources focus. The current fund focuses on available, spendable financial resources for the fiscal period. The current fund exists to be spent in accordance with the approved budget. The accounting system tracks the funds flowing into and out of the municipality in accordance with the budget. This measurement focus tends to emphasize the fulfillment of budgeted revenues and expenditures, with limited emphasis on the balance sheet. A contributory organization, in contrast, reports total assets and total liabilities, and the total costs of an operation. This method focuses on the costs of services, and corresponds to the economic resources measurement focus.

BASIS OF ACCOUNTING

The basis of accounting describes the point in time when a government records the

financial transaction in the accounting records. This refers to the timing when revenues, expenditures or expenses and their related assets and liabilities are recognized in the accounting system. This basis of accounting answers the question of “when.” When should the event be recognized in the accounting system: when the event transpires? when a bill is issued? when the cash is received or disbursed? There are several bases of accounting which answer the “when” question.

Cash Basis

The cash basis of accounting recognizes a transaction when the cash changes hands, either cash is received or cash is disbursed. This basis does not recognize the corresponding asset and liability of the transaction, thus not recognizing the results of operation on the accounts receivable, accounts payable or other “accruals.” By not recognizing the related accounts receivable or accounts payable, these accounts are typically understated or overstated based on the economic event, and generally not in conformance with acceptable accounting or reporting standards.

A checking account is an excellent example of the cash basis of accounting. One would pay bills based on the amount of cash remaining in the checking account which may or may not correspond to the amount of the bill to be paid. If one has 1,000 Kc to be paid, and only 400 Kc available in cash, a “balanced” checkbook would record the 400 Kc payment and not record the additional 600 Kc liability. While a checking account reports the proper cash basis amount, it understates the amount of the liability.

Thus cash basis accounting may significantly distort the financial position and results of operations. This basis can also be manipulated because governments can speed up or slow down cash receipts and disbursement near or at the end of a reporting period.

Accrual Accounting

The accrual basis of accounting recognizes a transaction when the economic event occurs, regardless when the cash changes hands. Revenues are recognized when measurable and earned. Measurable means the government knows the Kc value. Earned means when the economic event takes place. Thus when a contributory organization provides electricity to a home, revenues can be recognized when the electricity is received by the home owner and is provided by the utility. This meets the earned criteria. The government usually will record the revenue when it reads the meter thus fulfilling both the earned and measurable criteria. When the cash is received will not affect this transaction.

Expenses are recognized when the good or service is received, or is measurable and incurred. Thus when the government incurs the cost of providing the electricity, it records the expense and corresponding liability. When the cash is disbursed will not affect

this transaction. In practice, the government will typically record the liability periodically.

For fixed assets, the accrual basis would record the asset when the purchase is made and would depreciate the fixed asset over the life of the asset, thus amortizing the asset over its useful life. The cash basis would recognize the fulfillment of the expenditure at the time of purchase without amortizing the asset over its useful life. For the issuance of debt, the accrual basis would record the liability when the debt is incurred and would reduce the liability as the debt is retired. The cash basis would record the receipt of bond proceeds to cash and record the liability but would not record the receipt as a revenue. The modified accrual basis (see below) would record the bond proceed as an other financing source thus avoiding an artificial deficit in the accounting records.

Modified Accrual

The governmental model in the United States contains a third basis of accounting: the modified accrual basis. This basis records revenues when measurable and available. Measurable is defined as under the accrual method (when the government can determine the amount). Available is defined as the receipt of cash to meet current year liabilities outstanding at year end. Generally if a municipal invoice is paid within the normal fiscal year bill cycle, it is considered to be paid into current revenues. Expenditures generally are recognized in the same manner as in the accrual method (when the good or service is received), except for unmatured interest of general long term debt which is payable when due.

Summary

The accounting in the municipalities of the Czech Republic is substantially on a cash basis, but not uniformly or consistently so. Czech practices frequently do not make clear the significance of economic events that were not settled in cash during the accounting period.

ANNEX C

MUNICIPAL BOND ISSUES

No.	Municipality	Year of Issue	Maturity (Years)	Kc (Million)
1	Ostrava	1992	6	8.5
2	Sumperk	1993	5	20.0
3	Smrzovka	1994	7	115.0
4	Liberec	1994	5	100.0
5	Praha	1994	5	7,294.3
6	Pardubice	1994	5	50.0
7	Usti nad Labem	1994	5	150.0
8	Caslav	1994	8	90.0
9	Rokytnice nad Jizerou	1994	7	120.0
10	Veseli nad Moravou	1995	7	10.0
11	Rychnov nad Kneznou	1995	7	100.0
12	Plzen	1995	5	500.0
13	Mariauske Lazne	1995	5	200.0
14	Brno	1996	7	1,200.0
15	Frydek-Mistek	1996	5	150.0
16	Decin	1996	7	250.0
17	Kladno	1996	7	250.0
18	Ostrava	1996	5	1,318.2
19	Zidlochovice	1997	10	40.0
Total				11,966.0

ANNEX D

DETAILED BOND PROSPECTUS OUTLINE

- **Introductory Provisions**
 - Legal Basis
 - Local Approval
 - Ministry of Finance Approval
 - Purpose of the Issue
 - Principle Bank
 - Publication of Issue
 - Secondary Market
- **Characteristic and Terms of Issuance of Securities**
 - Type, Form and Shape of Issue
 - Total Amount of Issue
 - Issue Rate
 - Date of Issue
 - Maturity Date
 - Place of Payments
 - Interest Rate
 - Taxation
 - Legal Status of Issuer
 - Issuer's Collateralization
 - Tradeability
- **Basic Data of the Issuer**
 - Business Name and Address
 - Description
 - Property
 - Organizational Structure
- **Information on Municipal Activities**
 - Major Short and Long-Term Investment Goals
 - Long-Term Outlook
 - Major Investments During the Previous Three Years

- Information about Financial Status
 - Economic Results of the Current Year (UC 1-12 Summarized)
 - Yearly Balances of Accounts for Previous Three Years (UC 1 -12 Summarized)
 - Forecast of Revenues and Expenditures for the Next Five Years
 - Balance Sheet of the Current Year (UC ROPO 3-02 Summarized)
 - Previous Bond Issues
 - Bank and Other Credits Received
 - Other Liabilities
 - Unsettled Credits
 - Payment Insolvencies
 - Reserve Fund Balance
- Management and Administration Bodies
 - Name and Position of Leaders
- Closing Provisions